STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Illinois Bell Telephone Company	:	98-0252
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Application for review of alternative regulation plan.	:	
	:	
Illinois Bell Telephone Company	:	98-0335
	:	
Petition to Rebalance Illinois Bell Telephone Company's Carrier Access and Network Access Line Rates.	:	Consol.
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Citizens Utility Board and The People of the State of Illinois -vs- Illinois Bell Telephone Company	:	00-0764
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Verified Complaint for a Reduction in Illinois Bell Telephone Company's Rates and Other Relief.	:	

~~HEARING EXAMINERS'~~ POST EXCEPTIONS PROPOSED ORDER(Version I)

October 4, 2001

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By the Commission:

I. INTRODUCTION

In its Order entered on October 11, 1994, the Illinois Commerce Commission ("Commission") scheduled a five-year review to determine whether the Alternative Regulation Plan ("Plan") it authorized for Illinois Bell Telephone Company ("Ameritech Illinois", "AI" or "the Company") was meeting with the Commission's goals and statutory requirements. (Order, Docket 92-0448/93-0239 (consol.) ("Alt Reg Order")). Docket 92-0252 is that review proceeding. It was consolidated with Docket 98-0335 whereby AI requested rate restructuring and with Docket 00-0764 wherein CUB and the AG seek rate relief.

Pursuant to notice given in accordance with the law and the rules and regulations of the Commission, this matter came on for hearings before duly authorized ~~Hearing Examiners~~ Administrative Law Judges ("ALJs") of the Commission at its offices in Chicago, Illinois.

The following parties intervened or entered appearances, by their respective counsel, in the instant proceedings: Ameritech Illinois, ~~("the Company" or "AI"),~~ Staff of the Commission ("Staff"), United States Department of Defense ("DOD"), McLeodUSA Telecommunications Services, Inc. ("McLeod"), AT&T Communications of Illinois, Inc. ("AT&T"), Cable Television & Communications Association of Illinois ("Cable"), City of Chicago ("City"), Citizens Utility Board ("CUB"), Cook County State's Attorney's Office ("CCSAO" or "Cook County"), People of the State of Illinois ("AG") (CUB, CCSAO and the AG are collectively referred to as "GCI").

An evidentiary hearing was held in these consolidated proceedings from February 13, 2001 through February 23, 2001.

AI presented the testimony of the following witnesses: David H. Gebhardt; Thomas O'Brien; Mark E. Meitzen; William E. Avera; Rick Jacobs; Michael J. Barry; Timothy Dominak; William C. Palmer, Robert G. Ibbotson; David Sorenson; John Hudzik and Robert G. Harris.

Testimony on behalf of Staff was provided by: Robert Koch; Mary Everson; Dianna ~~Diana~~ Hathhorn; Bill Voss; Jeffrey Hoagg; James ~~Zolnierik~~ Zolnierek; Genio Staranczak; Judith R. Marshall; Sam McClerren; Mark A. Hanson; Alcinda Jackson; Joy Nicdao-Cuyugan; Alan S. Pregozen and Bud Green.

DOD presented the testimony of Harry Gildea. McLeod presented the testimony of Rod Cox. Cate Conway Hegstrom testified on behalf of AT&T.

The following witnesses testified on behalf of GCI/City: Ralph C. Smith; William Dunkel; Roxie McCullar; Thomas M. Regan; Lee L. Selwyn and Charlotte F. Terkeurst. Dr. Selwyn also testified for the City on certain issues.

Each of the witnesses identified above was available for cross-examination at the hearings. The record was marked "Heard and Taken" on March 2, 2001.

Initial Briefs were filed by DOD; CCSAO; People; CUB; City; AI; AT&T; McLeod and Staff. Reply Briefs were filed by Staff; DOD; GCI; AT&T; AI; Cable and McLeod. Partial Draft Orders were presented by AI, GCI, AT&T and McLeodUSA.

The Hearing Examiners Proposed Order in these consolidated dockets was issued on May 22, 2001.

Thereafter, Briefs on Exceptions were filed by: AI, Staff, AT&T, McLeod, DOD, and the GCI/City. AI set out its proposed language changes in a separate document designated as "Exceptions." The GCI/City also filed a separate "Exceptions" document, but in the form of a draft order which does not in any way identify their proposed replacement language as required under Section 200.830 of the Commission's Rules of Practice. See, 83 Ill.Adm. Code 200.830 (b).

Replies to Briefs on Exceptions were filed by: AI, Staff, AT&T, McLeod, and the GCI/City.

In addition, pursuant to an ALJ ruling issued on July 5, 2001, Briefs and Reply Briefs discussing the impact, if any, of the recent amendments to the Public Utilities Act ("Act") on the issues in this case, were filed by: AI, Staff, AT&T, ~~McLeud~~McLeod, and the GCI/City.

The Post Exceptions Proposed Order (Version I) applies the law currently in force. It is noted that despite the opportunity to do so, no party other than AI, sought to reopen the record and modify or submit new testimony after Public Act 92-22 went into effect on June 30, 2001. AI's singular (and narrow) request, was opposed by Staff and the GCI/City and rejected by the ALJ. No appeal of that ruling was taken.

Background

In 1994, the Commission entered an Order whereby AI would be regulated not under traditional rate of return regulation but rather by an Alternative Regulation Plan ("Plan") which caps its non-competitive rates and not its earnings. ("Alt Reg Order") In approving the Plan, the Commission had to make seven affirmative findings under Section 13-505.1 and further consider the policy goals set out in Section 13.501.1(a) and the provisions of Section 13-103. Since the plan was new and untested, the Commission ordered that there be a comprehensive review at the end of a five-year period to determine whether, and to what degree, it has met the settled statutory and regulatory goals.

The instant proceeding arose with Ameritech's March 31, 1998 filing of an application for review in compliance with the Commission's direction in the Alt Reg Order. (See, Alt Reg Order at 94-95). It is the first review of an alternative regulatory plan for a telephone company and the first review of Ameritech's Plan. In its Application, AI was required to address ten issues which set the scope of the instant review. It submitted the requested information in its direct testimony for this proceeding.

We agree with Staff that the analysis here is a historical one which seeks to assess how the plan has functioned up to now. (Staff Initial Brief at 28) To be sure, certain of the items only required a simple listing of changes occurring during the plan (e.g., items e, f, g, h), while others are more substantive and forward-looking, such as whether the adjustment factor in the price cap index should be modified and whether the plan has met each of the established statutory and regulatory goals (c, j). (See Alt Reg Order at 95, 179-192)). Some of the issues AI addressed were the subject of dispute and further analysis while others were primarily informational in nature.

The issue at this stage is whether the Plan, as established in 1994, has performed in accordance with both the statutory goals outlined in the Act and the regulatory goals and expectations set out in the Alt Reg Order.

II. THE 10 POINT REVIEW - Commission Specific Issues

Here we examine the ten specific items which AI was required to address in its application for review of the Plan. As we review the information provided, other evidence and arguments, we will be considering if the Plan should be continued.

(a) Does the inflation index and the manner in which it is applied provide an adequate reflection of economy-wide inflation?

AI's Position

AI maintains that the Gross Domestic Producer Price Index ("GDPPI") provided an adequate reflection of economy-wide inflation during the term of the Plan. According to AI, it is a widely accepted measure of economy-wide inflation for all goods and services produced by the U.S. economy and is used by the FCC and a number of state commissions in their price cap plans. At the time of the Plan's adoption in 1994, the fixed-weight version of GDPPI was the accepted and published inflation measure. In addition, a fixed-weight methodology was used to calculate economy-wide TFP and input price growth for purposes of establishing the X factor.

Subsequent to 1994, however, the Bureau of Economic Analysis ("BEA") of the U.S. Department of Commerce replaced the fixed-weight GDPPI with the chain-weighted GDPPI as the official measure of inflation. In addition, the Bureau of Labor Statistics has adopted chain-weighted measures in constructing economy-wide TFP, which also means that economy-wide input price growth is calculated on a chain-weighted basis.

Accordingly, AI maintains, the chain-weighted version of GDPPI should be used in the price index formula on a going-forward basis, along with chain-weighted versions of all other components of the X factor.

Staff's Position

In the Alt Reg Order, the Commission observed that a price regulation plan, such as the one at issue here, generally has at least two principal components: a measure of economy-wide inflation, and an offset to the inflation measure which measures productivity. (Alt Reg Order at 20). For that purpose, the Commission adopted the GDPPI as the measure of economy-wide inflation to be used in setting the price cap under the Plan. (Id. at 36.)

It further directed Ameritech to use a specific form of the GDPPI, called the "fixed weight" GDPPI, in its annual filings to date. The measure is produced by the Bureau of Economic Analysis ("BEA") and is revised periodically, with an annual revision occurring in August of each year. Staff tells us that this measure came into question in past annual filings due to the inconsistencies resulting from these periodic restatements in GDPPI data in a given year.

Staff provides the following example of how restating the GDPPI data can impact the amount of rate reductions in a given year. In Ameritech's Fourth Annual Filing, it reported the 1997-4th quarter GDPPI to be 114.4. In the Fifth Annual Filing, however, Ameritech reported the 1997-4th quarter GDPPI to be 113.4. According to Staff, the restatement of the GDPPI allowed AI to double-count 0.9% in inflationary change between the two filings. As a result, Staff claims, Illinois ratepayers were denied $9,248,761 in rate reductions in 1999.

Staff recommends that we discard the fixed weighted GDPPI in favor of another measure, i.e., the chain weight GDPPI. According to Staff, this chain weighted GDPPI is not restated in the same manner as the fixed weight GDPPI and, if adopted, would alleviate the problems it has described.

AG's Position

The AG contends that the manner in which the GDPPI has been applied has raised some issues. The BEA restates the GDPPI periodically, and if the effect of that restatement is not reflected in the price cap formula, AI can double count a portion of inflationary change to its benefit. Because these restatements can have a "drastic effect on GDPPI data and their consistency from year to year," the AG would have the Commission make appropriate adjustments to the annual rate filing process to correct this problem and insure consistency. In this proceeding, GCI witness Lee Selwyn proposed that the Commission adopt the chain-weighted GDPPI measure in the price index formula. Both Staff and Ameritech witnesses agreed.

Commission Observation:~~Analysis and Conclusion~~

All parties agree that the chain weighted GDPPI is now the appropriate measure of inflation. Further discussion follows in another section of this Order.

(b) An assessment of productivity gains for the economy as a whole, for the telecommunications industry to the extent data are available, and for Illinois Bell during the period that the alternative regulatory framework has been in place, and whether the adopted general adjustment factor should be modified.

AI's Position

AI notes that the Commission's 1994 Order established an X factor of 4.3%. It consisted of a productivity differential of 1.3%, an input price differential of 2.0% and a 1.0% consumer productivity dividend. The productivity differential and input price differential were based on a study of Ameritech Illinois' own historical productivity and input price performance over the 1984-91 time period. (Alt Reg Order at 21-22, 40).

AI submits that in using the most recent data released by the Bureau of Labor Statistics, the U.S. economy's productivity growth over the 1992-98 period was 1.0 percent and economy-wide input price growth was 3.0 percent.

AI proposes use of the industry-wide TFP and input price differentials that it presented. Both Dr. Harris and Dr. Meitzen testified that industry-wide data is the appropriate basis for an X factor because use of industry-wide data further breaks the link between rates and costs for the individual regulated company and better reflects competitive markets where all companies must perform at the industry level or suffer financially. In the event AI performs better than the industry average, the economic theory underlying price regulation holds that it should retain the benefits; to the extent AI performs less well than the industry average, ratepayers should not bear the burden of that performance.

AI dispute Dr. Selwyn's testimony that the X factor had failed to capture a reasonable portion of AI's productivity over the first term of the Plan. According to AI, Dr. Selwyn's "implicit X factor" analysis was nothing more than a reverse engineering of the financial data which GCI used to claim that AI is overearning. AI pointed out that this is not an accepted form of TFP analysis and that it says nothing about its productivity performance over the term of the Plan.

AI disputed the AG's claim that FCC ARMIS data showed a meaningful disparity between its reported earnings and those of other BOCs. The record shows, AI contends, that it treated certain industry-wide accounting changes (i.e., FAS 106, FAS 112 and FAS 71) differently for ARMIS reporting purposes than did the rest of the industry. As a result of this anomalous accounting treatment, Ameritech Illinois' total stockholder equity had dropped by 50% by 1994-95, which, in turn artificially inflated its earnings relative to the other BOCs. AI points out that even Ms. TerKeurst agreed that no meaningful comparison can be made between companies' earnings unless the underlying data is stated on a consistent basis. (Tr. 2174-75).

AI opposes the adoption of the FCC's 6.5% factor in this proceeding contending that it is not a valid productivity measure. AI witness Dr. Meitzen testified that the FCC X factor was not designed as a productivity measure but as a transitional mechanism; one that was imposed to reduce interstate carrier access rates. Dr. Meitzen concluded that the CALLS proposal served only to transform the FCC's X factor from a productivity factor into a transitional mechanism that reduces interstate rates at a certain pace and would not be linked to a specific measure of productivity. (AI Ex. 2.2, at 19.) AI enumerated other flaws with the FCC's X factor. AI claims that the FCC Staff used outdated data and improperly used only a single physical measure of local output. Further, the FCC's output specification did not match the sources of revenue growth. Also, AI argues the use of a residual earnings method to estimate capital costs by the FCC was improper. (AI Exceptions Brief at 2)

i. Ameritech Illinois - Specific Results

AI witness Dr. Meitzen updated the Ameritech Illinois TFP study which the Commission relied on in 1994. His testimony demonstrated that between 1984-91, AI's TFP growth averaged 2.2% and economy-wide TFP growth was 0.9%, for a TFP differential of 1.3%. Over the 1992-99 period, Ameritech Illinois' output growth averaged 4.6%, input growth averaged 0.5% and TFP growth averaged 4.2% annually. Based on the current BLS data referenced above, this results in a current TFP differential of 3.1% and an input price differential of 0.5%, for an X factor of 3.5%. (Am. Ill. Ex. 2.2, p. 5).

ii. Local Exchange Industry Results

To develop local exchange industry TFP results, AI witness Dr. Meitzen used the Total Factor Productivity Review Plan ("TFPRP") model, developed by the United States Telecom Association ("USTA") in conjunction with his consulting firm, which measures TFP growth for the local exchange carrier industry. The TFPRP is based on the same methodology as the Ameritech Illinois-specific TFP studies, is updated periodically and, currently, model results are available through 1998. For the 1992-1998 period, the TFPRP calculates average annual output growth of 4.7 percent, average annual input growth of 1.3 percent and average TFP growth of 3.4 percent annually for the LEC industry. Using the above referenced BLS data, the industry TFP differential is 2.4 percent, and the input price differential is 0.9%, for an X factor of 3.3%. (AI Ex. 2.2, pp. 3-4).

Staff's Position

Staff explains that the general adjustment or "X" factor in the price cap formula consists of three elements: (1) a productivity differential; (2) an input price differential; and (3) a consumer dividend. The productivity differential measures the difference between telecommunications total factor productivity gains and overall economy total factor productivity gains. The input price differential measures the difference between telecommunications input prices and economy-wide input prices, and the consumer dividend is a judgmental factor imposed by the Commission based upon its expectations regarding gains that arise from technological and/or regulatory change that the Commission anticipates.

Staff notes that in 1994, the Commission set the productivity differential at 1.3%, the input price differential at 2.0% and the consumer dividend at 1.0% (Alt Reg Order at 38). This decision was based on the Commission's analysis of Ameritech's productivity and input price performance *vis a vis* the economy as a whole and its expectations for the future. At the time of the Alt Reg Order, i.e., 1994, industry productivity and input price data was unavailable.

In this proceeding, Staff proposes that both productivity and input price differentials be based on industry rather than Ameritech-specific data, a proposition to which GCI witness Dr. Selwyn and Ameritech witness Dr. Meitzen concur. This is primarily because the "X" factor should replicate as near as possible what would occur in a competitive market, and pricing in a competitive market closely follows industry productivity and input price averages.

Consequently, Staff recommends that the Commission adopt a productivity differential of 2.3%. This recommendation is based on the results of the United States Telecom Association ("USTA") productivity study, filed as attachments to the testimony of Ameritech witness Mark E. Meitzen. (See AI Ex. 2.1, Attachment 2.) In addition, Staff advocates adoption of an input price differential of 1% based upon figures filed in the same attachment. Finally, Staff proposes a consumer dividend of 1% which fulfills the requirement under Section 13-506 (b)(5) of the Public Utilities Act that an alternative regulation plan "...specifically identifies how ratepayers will benefit from any efficiency gains, cost savings arising out of the regulatory change and improvements in productivity due to technological change." 220 ILCS 5/13-506(b)(5). In total, therefore, Staff recommends an "X" factor of 4.3%.

AG's Position

In establishing the price index, the AG maintains, the Commission sought to capture the "competitive outcome" in which industry productivity improvements and cost conditions are flowed through to consumer prices. It adopted a 4.3% X factor, consisting of a 3.3% productivity factor and a 1% consumer dividend, which is subtracted from the GDPPI inflation rate to determine the percentage amount of aggregate rate increases or decreases under the price index plan, subject to service quality performance and exogenous factor adjustments. The 3.3% productivity factor was intended to mirror the "historical differentials between economy-wide and Illinois Bell input prices." Id. at 39. The 1% consumer dividend was based on the Commission's expectation that AI would exceed the 3.3% productivity factor, and that consumers should benefit by adjusting AI's rates by this additional 1%. (Alt. Reg. Order at 39).

The AG refers to GCI witness Dr. Selwyn's testimony indicating that the X factor, as applied, failed to capture a reasonable portion of AI's productivity. (GCI Ex. 3.0 at 22-23.) To test the effectiveness of the X factor, the AG states, Dr. Selwyn calculated what productivity factor would have resulted in AI earning the authorized rate of return of 11.36%. His "implicit X-factor" analysis showed that AI's actual productivity during the course of the plan was 11.06%. According to the AG, this shows that the 4.3% offset has been unreasonably low and that ratepayers have not received a reasonable portion of the productivity savings achieved during the course of the plan.

The AG notes Dr. Selwyn's testimony, that the insufficiency of the 4.3% X factor is also demonstrated by AI's reported earnings of 19.15% for intrastate operations (later reduced to 18.82%) and 23.89% for total company operations for 1999. AI's and Ameritech's reported earnings, compared with FCC ARMIS data for the other Bell Operating Companies, ("BOCs"), shows a great disparity between Illinois Bell, Ameritech and other BOCs. Indeed, the AG claims, AI's return on rate base is almost as high or higher than the BOCs overall return on equity, and Ameritech's own reported return on equity is several hundred basis points higher than the other BOCs return in every year except 1996. These notably high returns on both Illinois rate base and Ameritech stockholder equity, the AG claims, are strong evidence that the X factor has been unreasonably low and that ratepayers have been paying excessive rates as a result.

The AG also notes that the FCC has adopted a 6.5% adjustment factor, or a "rate reduction factor," as a result of the "CALLS" settlement proposed by the BOCs, including AI's parent SBC. Although this 6.5% adjustment factor does not reflect all of the annual cost savings identified in this docket, the AG maintains that it is a more accurate adjustment that will return a reasonable amount of savings to consumers while preserving the efficiency incentives that are part of the price cap plan.

According to the AG, the implicit X factor analysis, AI's extraordinarily high rate of return on rate base, and the fact that AI, Ameritech and SBC proposed a 6.5% rate reduction adjustment in the federal jurisdiction, all demonstrate that the 4.3% X factor was understated and must be adjusted upward. In their Joint Reply Brief, the GCI/City assert that AI has achieved efficiencies well beyond the 4.3% x-factor.

Commission Observation: ~~Analysis and Conclusion~~

The Commission notes that this item raises a dispute which will be subject to analysis in another section of this Order.

(c) Whether the adopted monitoring and reporting requirements should be retained or adjusted.

AI's Position

For its part, Ameritech Illinois proposes to streamline the monitoring and reporting requirements.

AI contends that the reporting requirements in the Commission's 1994 Order could be streamlined on a going-forward basis to reduce the costs of regulation, without any loss in appropriate Commission oversight capabilities. First, AI proposes that items (1-6), which are earnings-related in nature, be eliminated because they are not appropriate in a price regulation plan. AI notes that the Commission's stated rationale in 1994 for requiring this information was that high earnings could provide an "early warning" that the productivity offset may have been misspecified. In practice, however, AI asserts that the productivity offset was not misspecified and that there is no reason to believe that it will be misspecified going forward. Second, AI submits an annual report on March 31 of each year which details its financial performance over the preceding calendar year and sufficiently sets forth other information previously required. AI contends that items (8-11) and (13-14) are unnecessary because those items are addressed in the annual price cap filings. With respect to the infrastructure report, AI contends that the report required by the SBC/Ameritech Merger Order should substitute for item (7).

Staff's Position

Staff notes that Section 13-506.1 (d) of the Public Utilities Act ("PUA") provides, in relevant part, that:

> Any alternative form of regulation granted for a multi-year period under this Section shall provide for annual or more frequent reporting to the Commission to document that the requirements of the plan are being properly implemented.

In accordance with this statute, Staff claims, the Commission cannot extend the Plan without also retaining some type of monitoring and reporting requirements. Staff further asserts that the information supplied by Ameritech pursuant to such reporting requirements is valuable to the Commission, the Staff, and the public in determining whether Ameritech is complying with the conditions of the Alternative Regulation Plan.

Currently, in its annual price cap filing, Ameritech is required to report on the following:

(1) total Company and Illinois jurisdictional rate base for the preceding calendar year adjusted to reflect regulatory treatment ordered in Dockets 92-0448/93-0239;

(2) total Company and Illinois jurisdictional operating revenue and expenses for the preceding calendar year adjusted to reflect the regulatory treatment ordered in Dockets 92-0448/93-0239;

(3) other income and deductions, interest charges, and extraordinary items for the preceding year (with explanations);

(4) preceding calendar end-of-year capital structure;

(5) calculated total Company and Illinois jurisdictional return on net utility rate base and total Company return on common equity;

(6) statement of Sources and Applications of Funds for the preceding calendar year;

(7) description of proposed projects and amounts to be invested in new technology (regarding the Company's $3 billion infrastructure investment) for the current calendar year and a comparison with the actual projects and amounts invested in new technologies during the preceding calendar year;

(8) calculation of the current price cap index and actual price indexes including the formulas used, the inflation factor and its source, the general adjustment factor, the exogenous factor and a description of its calculation, and the service quality component and a description of its calculation;

(9) a description of new services offered in the preceding calendar year, including the price of each and its effect on the calculation of API;

(10) demand growth by revenue basket in the preceding calendar year;

(11) summary of price changes initiated under the Alternative Regulatory Plan in the preceding calendar year;

(12) a demonstration that Section 13-507 of the Act has been complied with during the preceding calendar year;

(13) a summary report on Ameritech's quality of service during the preceding calendar year; and

(14) a summary report on the exogenous events that affected the exogenous factor of the price cap index formula.

(See, Alt. Reg. Order, Appendix A at 7-10).

Staff recommends that the Commission order the reporting and monitoring requirements to be continued, notwithstanding any objections. According to Staff, the reports are intended to document that the requirements of the plan are being properly implemented such that every requirement or condition of the alternative regulation plan should be addressed in these reports. Otherwise, the Commission, the Staff, and the many parties with a legitimate interest in the workings of the Plan would be unable to make an informed assessment.

According to Staff, the individual reporting requirements are also meaningful in a regulatory sense. It is necessary that AI be required to report on service quality, (item (13 above), in light of its recent, well-publicized and admitted failures in this regard. Likewise, Ameritech should be required to report on infrastructure investment, given its own commitment in the merger proceeding to continue to invest in its infrastructure. (See, Merger Order 98-0555). Similarly, Staff claims that the Commission's authority to rescind alternative regulation plans that fail to satisfy the statutory requirements for such plans, means that AI should be required to produce basic financial information, especially where, as is the case with respect to items (1)-(6) above, the information is not available from other sources. While Staff recognizes that Ameritech already files information responsive to items (8)-(11), (13) and (14) above, it would have there be a one single source of information regarding Ameritech's performance under the plan, which the price cap filings do not provide.

AG's Position

The AG basically agrees with Staff's position that the reporting information provided each year in the annual rate filing continues to be necessary to enable the Commission to monitor that the plan is being properly applied and that the intended benefits are realized. Also, the GCI/City maintain that without a clear directive from the Commission to provide certain types of information, the Commission and interested parties will be unable to obtain it when needed in the future.

Commission Observation: ~~**Analysis and Conclusion**~~

While the question of reporting arises in our historical assessment, it is a forward-looking issue which we defer to a later section of this Order.

(d) The extent to which Illinois Bell has modernized its network and additional modernization plans for the near term.

AI's Position

AI witness Gebhardt's testimony indicates that substantial investments were made in deploying additional fiber facilities through the network. (Am. Ill. Ex. 1.1) He explains that fiber facilities improve efficiency and reliability in the transport of voice and data. And they are an essential building block for providing advanced series of the future. Further, Mr. Gebhardt notes that AI has completed its deployment of SS7 capability, a technology which improves network efficiency and call handling processes, and provides capabilities for the Ameritech Inteiligent Network platform. In addition, Mr. Gebhardt testified, the Company expended many millions to modify its network and open it to completion.

A summary of Ameritech Illinois' investments over the 1994-99 period was put into record (Am. Ill. Ex. 1.1, Schedule 3). as were its modernization plans for the future. (See, Jacobs testimony, Am. Ill. Ex. 5.0).

AI discussed network modernization largely in relation to other aspects of the Plan. Several of those arguments are relevant here. For example, AI responded to CUB's claim that the Company only invested a "net" of $300 million in its network and, therefore, is not infusing new capital into its business. AI maintains that the correct measure of its investment in its network is the $3.7 billion presented by Mr. Gebhardt, not the net figure cited by CUB. AI notes that the Commission ignored Dr. Selwyn when he made a similar argument in the 1994 proceeding and it has not improved with age.

Similarly, AI responded to the argument of the Attorney General and Cook County that AI failed to invest in aspects of the network which benefit POTS service. They claimed that Project Pronto does little to benefit POTS customers. According to AI, these arguments fundamentally misrepresent Project Pronto. AI states that Project Pronto is not a "DSL project"; it is an overall network modernization program which benefits all customers. In fact, AI explained, because the DSL aspects of Project Pronto are currently being deferred, Project Pronto now benefits only POTS services.

AI also denies that installation delays in the latter half of 2000 resulted from any lack of network investment. The Company notes that service quality performance for Trouble Reports per 100 Access Lines improved steadily throughout the term of the Plan. Such performance shows that headcount issues, not network investment, led to the installation problems.

Staff's Position

Staff avers that AI's network modernization reports must be submitted in sufficient detail to allow the Commission to determine (a) whether and how each investment was made, (b) whether it serves to maintain the quality of Ameritech's network, and (c) whether the investment is in the interest of all of Ameritech's customer classes. According to Staff, these reports are audited by an independent third party selected by the Commission and must be expressly approved by the Commission. With these measures in place, Staff maintains that the Commission need not address anything other than the reporting and monitoring aspect of the matter in this docket.

AG's Position

According to the AG, there were insufficient network access lines available for installation in the latter half of year 2000, resulting in extensive delays in the installation of "Plain Old Telephone Service" or POTS. During this time, the AG notes, consumers waited weeks and even months for installation of a simple telephone line or repair in some areas of the state, the number of out of service complaints increased, and AI failed to return an increasingly greater number of customers to service within the 24 hour benchmark.

Despite AI's reported $3.7 billion infrastructure investment, the AG notes that there has been service quality degradation. According to the AG, AI's inadequate network invested has affected DSL expansion; has been one of the primary reasons for the Company's inability to comply with the Commission's installation requirements; and also served to undermine the Company's ability to provide advanced Internet services. It was SBC's chairman, the AG claims, who publicly attributed AI's service quality problems to inadequate investment in infrastructure. (GCI Ex. 11.0 at 68-69.) Similarly, GCI witness Charlotte TerKeurst determined that investment in network access facilities has been inadequate to keep up with demand.

Ms. TerKeurst noted that almost $1 billion of AI's $3 billion commitment was spent on just one of AI's high margin services, Project Pronto, which extends loop reach for current and future broadband services offered by an Ameritech affiliate. All of this, the AG claims, compels the conclusion that the Plan incentives did not lead to an adequate portion of the $3.7 billion investment being directed to basic infrastructure. And, regardless of how much AI spent on opening its networks, the AG claims that its investment was ineffective in facilitating meaningful competition.

In view of AI's service quality problems, the AG maintains that the Commission should not lessen the reporting requirements on infrastructure investment. And, the increased reporting detail required by Merger Order should also be a part of the Company's annual rate filings. According to the AG, the annual infrastructure investment reports that were ordered in the Merger docket should be relied on in determining whether the existing infrastructure investment should be increased to keep any alternative regulation plan in compliance with statutory requirements.

Commission Observation: ~~Analysis and Conclusion~~

No party denies that AI spent the amounts to which it committed. AI has put into the record the necessary evidence and Staff informs us of the detail in reporting on its investments to which AI is subject.

(e) A listing of all services in each basket and a report of the cumulative percentage changes in prices for each service during the period the price cap mechanism has been in effect.

AI's Position

Ameritech Illinois maintains that it supplied the required list of services and the report of cumulative percentage price changes for those services. (Am. Ill. Ex. 1.0, Schedule 6). According to AI, the data demonstrate that a wide range of noncompetitive services experienced significant rate decreases over the first five-year term of the Plan. AI explains that Price reductions, in general, were targeted at services where contribution levels were relatively high and where price reductions would encourage broader deployment of the Company's services. Also, the Company attempted to avoid reductions for those services, for example the residential network access line, where the price-to-cost relationship is too low today.

AI disputes Staff's contention that it had overstated the benefits to consumers from the rate reductions which resulted from the Plan. AI explained that not only did consumers benefit from the rate reductions themselves, but that the stimulated demand, resulting from these reductions, produced a separate and distinct benefit to consumers by increasing consumer surplus.

AI also responded to arguments made by the AG that the Company should have, and had not, decreased the prices for residence network access lines. AI states that it had made clear in the original Alternative Regulation Plan proceeding that it did not intend to reduce residence network access line prices. AI states that current network access lines prices are too low and that it would have been irrational from an economic and policy perspective to reduce those rates. AI further maintains that rate reductions should logically flow in the direction of those customers who use its network, as opposed to those who make little or no use of it.

Staff's Position

After reviewing AI's response to this requirement, Staff is of the opinion that Ameritech's characterizations concerning actual price changes are accurate. Staff, however, does not support AI's estimate of the cumulative revenue reductions resulting from these rate reductions where Ameritech asserts that the Plan has resulted in total benefits to consumers on the order of $943 million.

According to Staff, Ameritech's revenue reduction calculations do not take into account increases in demand for services that resulted from rate reductions. Staff states that the impact of the demand stimulation is an increase in revenue and, therefore, Staff believes that the figures overstate what the benefit to consumers under the Plan. As support for its argument, Staff points to Ameritech's own admission that it targeted rate reductions to those services for which demand would increase because of such rate reductions (i.e. for price elastic services). Where Ameritech believes that rate reductions would result in increased demand, its calculation of cumulative revenue reductions should reflect this increased demand.

Further, Staff notes, Ameritech continued to include revenue reductions for services declared "competitive" in its calculation of consumer benefits. Staff views AI's calculation is as follows: multiplying the mandated rate reductions in the first year ($30 million) by five, then adding that figure to the mandated rate reductions in the second year (after it has been multiplied by four); adding that cumulative total to mandated rate reductions in the third year (after it has been multiplied by three), and so on. (Tr. 396). In other words, Ameritech continued to count as consumer "benefits" the reductions in rates that did not in fact occur, or at best, occurred outside of the Plan.

According to Staff, almost all business services were subject to the Plan at its inception, and almost none are subject to it now. Revenues in the business basket subject to the Plan have actually declined from $409 million in 1996 to $18 million today. Yet it appears to Staff that Ameritech continues to count rate reductions for that $391 million worth of reclassified services as "benefits" of the Plan. In Staff's view, Ameritech cannot justly claim that customers benefit from service reclassification. Although Staff was unable to provide a sufficient proxy for the actual savings received by customers, it maintains that Ameritech's estimated benefit to consumers is significantly inflated.

AG's Position

According to the AG, the AI list shows that in all the years of the Plan's operation, it has made no reductions to the residential network access line ("NAL") charge, which is the most basic and inelastic element of local exchange service. Indeed, the AG argues, the network access line charge is a prerequisite to receiving any other landline telecommunications service, (including long distance) and is paid by customers every month, regardless of whether or not they make calls on the network.

The AG claims that by giving AI the flexibility to decide how rate reductions would be allocated among various services, the Plan allowed the Company to ensure that the most inelastic portion of the local phone bill never decreased while most of the benefits of alternative regulation went to high-volume customers. Not only is this pricing structure inequitable, the AG maintain, but it runs counter to the Commission's policy to guard against "Ramsey pricing." (See Alt. Reg. Order at 70).

During the plan, the AG argues, AI made only modest reductions to those services in the residential basket most often used by residential customers: the Company reduced usage rates for band A, (where customers place the most local calls), by only 3.85%; less-frequently placed band B calls enjoyed a higher discount of between 21 and 33%; and the major reductions, ranging from 42% to 297%, resulted from increasing the residential volume discount, which is based on total usage. Hence, the AG asserts, AI linked rate reductions to increased use of its system, which drastically limited rate reductions to low or moderate use customers.

The AG notes that the Plan included certain pricing constraints such as limiting pricing flexibility to 2% of the API and requiring rate reductions for each of four service baskets in an effort to insure that all classes of customers benefited from the anticipated rate reductions. (Alt. Reg. Order at 69-70). AI's failure to reduce the NAL rate and Band A usage and its use of volume discounts to implement rate reductions under the Plan, the AG claims, show that the plan failed to benefit all classes of customers and requires that the plan be modified going forward.

Commission Observation: ~~Analysis and Conclusion~~

There are issues raised here which will be discussed further in this Order.

(f) A listing of any services which have been withdrawn during the period.

AI's Position

To satisfy its requirement, Ameritech Illinois provided a list of all services which were grandfathered or withdrawn during the first five-year period of the Plan. (Am. Ill. Ex. 1.0, Schedule 2). In general, the Company sought to grandfather and/or eliminate services where demand was low, continued product support costs were high and/or technological advances created a better substitute service. For example, Basic 911 Type I service was grandfathered in 1996 as better, more reliable 911 service became available. At the time the service was grandfathered, only two customers subscribed. There is currently no demand for this service.

Staff's Position

Staff considers the list AI provided to be complete, unobjectionable, and as such raises no issues for this proceeding.

AG's Position

According to the AG, the list which AI provided did not specify which were services, which were payment options, or which applied to the residential, business, carrier or other service category. As such, the AG claims, the listing does not help the Commission discern the significance of the discontinuation of these services.

Commission Observation: ~~Analysis and Conclusion~~

Based on the foregoing discussion, we find no issue raised for this proceeding.

(g) A listing of all services which have been reclassified as competitive or noncompetitive during the period.

AI's Position

As required, Ameritech Illinois provided a list of all noncompetitive services which were reclassified as competitive over the first five-year period of the Plan. (Am. Ill. Ex. 1.0, Schedule 3). According to AI, a significant number of services -- particularly business services -- are now available from multiple providers in Ameritech Illinois' service territory. This result, AI maintains, is consistent with both the statutory construct, because alternative regulation plans only apply to noncompetitive services, and with the policy underpinnings of price regulation, which is intended to determine prices where market forces do not exist.

AI disputed both Staff's and the AG's position that the Company's reclassification of services had weakened the Plan. AI contends that these reclassifications reflected the increased competition in the marketplace during the first term of the Plan. AI pointed out that many of its reclassifications had been approved by the Commission or had not been the subject of contention. For example, the Commission approved the reclassification of WATS/800 service, payphone services, virtually all operator services and that the Commission's decision in the Bands B and C usage docket only impacted customers with 12 lines and less. AI notes that it had predicted an even larger shift of services into the competitive category in the proceeding where the Plan was adopted. AI further states that it had acted in good faith with respect to each reclassification.

Staff's Position

Ameritech has produced the required list which Staff considers to be accurate to the extent that it correctly describes which services have been reclassified. But, Staff argues, the list does not provide any insight as to the impact on the Plan resulting from reclassifying a service as competitive. It is Staff's opinion that Ameritech's reclassification of services have significantly weakened the Plan. Staff discussion on the impact of competitive reclassification appears in a subsequent section of this Order.

AG's Position

The AG observes that while AI witness Gebhardt's direct testimony provides the Commission with a list of services which AI reclassified as competitive since the inception of the plan, he did not further explain that many of those reclassification have not withstood Commission scrutiny. For its part, the AG notes that some of these reclassifications, (including business usage for band B and C calls and operator assisted and calling card usage and usage originating in MSAs 1,2,3,6,7,9 and 15), were reversed by a Commission order in October 1995, that was later affirmed by the court. See, Illinois Bell Telephone Co. v. Illinois Commerce Commission, 282 Ill.App.3d 672 (3d Dist 1996). While AI also lists a 1998 reclassification for all business services in Illinois and for residential service in 19 exchanges as competitive, the AG notes that a Commission-initiated investigation into the propriety of those reclassifications, i.e., Docket 98-0860, is pending.

The AG asserts that the result of reclassifying a service as competitive is that it removes the service from the alternative regulation plan. Thus, services classified as competitive are no longer subject to the pricing constraints of the plan, nor are revenues from the services included in the calculation of the service quality adjustment. According to the AG, the reclassifications pursued by AI during the plan, removed about 35% of its revenues from the Plan, and left it significantly less effective in both retaining the benefits of productivity for consumers and protecting consumers from market abuse. In the AG's view, the plan needs revisions to eliminate the incentives to prematurely reclassify services as competitive and raise rates unconstrained by competition or the price cap index.

As part of alternative regulation, the GCI/City propose that the Commission require the Company to maintain appropriate records to enable the Commission and the parties to review the relevant data to assess the effect of reclassifications on rates and on the operation of the Plan. The report should include the data Staff requested, but was unable to obtain from the Company during this review proceeding, i.e., the revenue received from rate increases to reclassified services plus unrealized savings that would have occurred had the services remained under the price cap mechanism. Other important information is whether the reclassification was subject to Commission review and ultimately changed.

Commission Observation: ~~**Analysis and Conclusion**~~

The Commission finds that AI provided the list which the Commission required in its 1994 Order. ~~complied with the instant requirement in letter if not in spirit. An issue has been raised with respect to reclassification which will be explored further in other sections of this Order.~~

(h) A summary of new services which have been introduced during the period.

AI's Position

Ameritech Illinois provided a list of the new services which it introduced during the first five-year period of the Plan. (Am Ill. Ex. 1.0, Schedule 4). It claims that new services were an important source of revenue for the Company and are producing about $200 million in annual revenues.

For example, AI points to "Privacy Manager", which is a highly innovative offering allowing customers to pre-screen their calls and eliminate telemarketing or other unwanted intrusions. AI notes that it was the first RBOC in the nation to offer this service and it has been widely imitated. AI also states that it had experimented in the marketplace through a large number of promotional offerings and introduced optional calling plans. Today, according to AI, a substantial portion of its residential customers take service under one of these plans.

AI disputs Staff's and the AG's claim that these were not "new" services within the terms of the Plan and had been misassigned to the "Other" basket. AI explains that optional calling plans provide customers with new pricing options, which are not available under the standard tariffed offerings. AI points out that most of the innovation in telecommunications today involves the packaging and pricing of services, not new capabilities per se. Because these calling plans are optional and because customers will only subscribe to them if they benefit from them, AI contends that they properly belong in the Other basket, which contains other optional residence services, such as vertical features.

AI further states that treating optional calling plans as new services properly recognizes administrative problems associated with bringing new service under the index. According to AI, it needs experience in the marketplace to develop enough demand information to reset the API. AI also points out that the FCC had encountered the same definitional issue under the federal price cap plan and had defined new services consistent with AI's approach.

AI further notes that, under the AG's approach, it would not have been able to offer these optional calling plans at all, due to the pricing rules applicable to existing services. AI maintains that customers would not have benefited from such an end and that the AG should not use the basket structure as an back door means to prevent the offering of services which many thousands of customers subscribe to, and benefit from.

Staff's Position

Staff does not dispute the completeness of the list Ameritech has provided. It is of the opinion, however, that a number of the services described by Ameritech as "new" are not so in reality. In Staff's view, the great majority of the revenue Ameritech has realized from new services (apparently over 90%) is derived from so-called "optional calling plans," which are little more than repackaging of Band A, B, and C residential services at differing rates. The significance of this repackaging, according to Staff, is that it provides the rationale for Ameritech to place these optional calling plans in the "Other Services" Basket, rather than the "Residence" Basket.

These services, Staff claims, are all basic residential services, which the vast majority of customers need and use regularly. To classify them as "other" rather than "residential" makes little sense, and benefits no one but Ameritech. In authorizing the current Plan, Staff asserts, the Commission surely expected some degree of innovation in product, not simply in the novelty of marketing of same.

Staff considers improper classification of this sort to be a problem because shifting what is clearly basic residential service revenue to the "Other Services" basket, compromises the ability of the price cap plan to provide reductions in rates for residential services. The current four-basket system was established to limit the likelihood of discrimination against residential customers. As more revenue is transferred out of the Residence Basket to the Other Services Basket, Staff contends, more rate reductions will also shift to the Other Services Basket. Since there have been no reductions for local call plans in any of the annual filings under the Plan, Staff believes it fair to conclude that non-essential services are receiving rate reductions that otherwise would have been earmarked for basic residential services. To remedy this unfair situation, Staff recommends that local calling plans be moved out from the Other Services Basket to the Residential Basket.

AG's Position

According to the AG, the AI list of new services lacks sufficient detail for the Commission to draw any conclusions about the nature of the new services or whether the plan has led to more new services than would have been offered in the absence of alternative regulation. The listing fails to provide a description of the services or to indicate whether the new services fall in the business, carrier, residential or other category.

Some of the "new services" such as the 1995 usage discount plans, the 1996 ValueLink offering, the 1997 residence local call plans, and the 1999 Anytime rate calling plan, the AG contends, merely represent different billing options for existing services. The AG notes GCI witness TerKeurst's explanation that a bundle of services that are already available to customers on a stand-alone basis "is properly labeled as a restructured service because it modifies the method of provisioning and charging for the same services previously available." (GCI Ex. 11.0 at 61). Such "restructured" services, the AG maintains, do not represent innovation or an expansion of service options.

The GCI/City further note that in "repackaging" local usage, AI increased the rates for Band A, and increased the average rate for Band B calling in its Simplifive and CallPack programs. (See Order at 31-32; Docket 00-0043 (Jan. 23, 2001). The only calling plan rate lower than the regularly tariffed rate was for Band C usage. Band C tariffed usage rates were increased from 4 to 10 cents per minute after their competitive reclassification, compared to the calling plan rates of 5 cents per minute and 10 cents per call. These "new services" were really rate increases for all but a subset of consumers with a particular calling pattern. (Id. at 33) Further, GCI/City agree with Staff's view that AI showed innovations in marketing and not in product.

While AI refers to one service -- Privacy Manager – to show its "innovation" and refers to "a large number of promotional offerings" and optional calling plans, AI witness Gebhardt did not describe any of its promotional offerings. More importantly, GCI / City claim, Mr. Gebhardt admitted that AI's innovations under the Plan were in the area of pricing, "not new services, per se."

Commission Observation: ~~Analysis and Conclusion~~

AI provided the list required. The Commission notes that it will examine the issues raised herein in another section of this Order.

(i) Information regarding any changes in universal service levels in Illinois Bell's service territory during the price cap period.

AI's Position

Ameritech Illinois provided information regarding service levels during the period that the Plan was in effect. Based on data from FCC reports, telephone subscribership ranged between 93.6% and 93.8% for the State of Illinois for the four-year period immediately prior to implementation of the price cap plan. For the five years of the Plan's operation, the comparable data ranged between 91.8% and 93.6%. Accordingly, to AI, data is not available for Ameritech Illinois' service territory specifically. (Am. Ill. Ex. 1.1, pp. 62-63).

Although the data suggest a decline in universal service over the last five years, AI maintains that there is no evidence that this problem is related to the Plan in any way. If anything, AI claims, the Plan has resulted in price reductions, which logically would have had a positive impact on subscribership. Furthermore, AI maintains that its rates generally are low relative to those of incumbent LECs in other states. In light of these considerations, AI contends there must surely be something other than price that is driving the results.

AI states that study has been commissioned by Ameritech Illinois, the ITA and UTAC with the involvement of Commission Staff, to determine what is causing these results. This study should be available in the relatively near future. If the Commission were to ultimately conclude that there is a subscribership issue in Illinois, a separate proceeding could be established to determine what the problem is and evaluate the possible solutions.

Staff's Position

According to Staff, Ameritech has provided the requested information on this issue. (Ameritech Ex. 1.1 at 68-69).

Staff informs that telephone subscribership (percentage of households with telephones) declined in Illinois between 1995 and 1999, while it has increased nationwide. Even though subscribership increased in 2000, Illinois' levels are still less than the national average. This problem, however, cannot be attributed conclusively to the Plan in Staff's opinion, inasmuch as other Illinois incumbent local exchange carriers ("ILECs") have lower subscribership levels in their service territories than Ameritech has in its territory. Moreover, the Commission, the Staff, and incumbent carriers, including Ameritech, have joined together to study the causes of low subscribership in Illinois, and address them to the extent possible. Staff, therefore, is of the opinion that Ameritech is in compliance with this requirement and that this is not an issue for this proceeding.

AG's Position

The AG notes that AI only provided the FCC data on Illinois telephone subscribership. This document, the AG states, shows a decline in telephone penetration during the course of the plan from 93.6% in 1994 and 1995 to 92.2% in 1997. In his testimony, AI witness Gebhardt admitted that Illinois' standing in comparison to the rest of the nation appears to be low, whether one looks at current or historic data.

According to the AG, GCI witness Dunkel provided more specific universal service information, showing that in 1999, (the last year for which annual information is available), Illinois reached a low point of 91.8% telephone penetration. Mr. Dunkel demonstrated that telephone penetration rates in Illinois have declined during the course of the Plan, and that the FCC singled out Illinois as the only state with a "significant decrease" in penetration from 1983 to July, 2000. Mr. Dunkel also indicated that Illinois is 2.4% below the national penetration rate, whereas in 1995 it was only .3% away from the national average.

The AG maintains that AI provides 85% of the access lines in Illinois and accordingly the Illinois penetration rate shown in FCC data could reasonably be linked to AI's penetration rate. The 1.8% decline from 1995 to 1999 substantially exceeds the 1.4% change Mr. Gebhardt admitted was statistically significant, the AG argues, and should be a matter of concern to the Commission in this evaluation of alternative regulation

Whereas AI offers no definitive explanation for the decline in penetration rates the GCI/City suggest that the repackaging of non-competitive local usage in calling plans at higher local rates, the aggressive sales techniques for optional, vertical features, and poor quality of service, are easily understood reasons for both the disconnection for lack of payment, and consumers' avoidance of AI's system altogether.

Commission Observation: ~~Analysis and Conclusions~~

While universal service is a matter of great concern to the Commission, we see no evidence that the Plan is directly implicated in the low level of subscribership. We find that the conclusions that the GCI/City suggest are not sustainable without an extensive and comprehensive analysis. To this end, as both AI and Staff inform us, there is a study underway to ascertain the real cause of this problem and we will proceed further on that basis. This is not the proper proceeding to delve into an issue of this nature and magnitude.

(j) Whether, and the extent to which, the adopted regulatory framework has met each of the established statutory and regulatory goals?

Commission Observation: ~~Analysis and Conclusions~~

At this juncture, the Commission's focus in this Order will ~~now~~ be centered on the particular statutory goals and expectations under which we authorized the inception of the current Plan. Our analysis here maintains a historical perspective as we assess how the Plan has functioned over the initial term and begin to explore the type and extent of modifications needed in going forward.

III. THE STATUTORY CRITERIA AND GOALS

When approving Ameritech Illinois' Alternative Regulation Plan in 1994, the Commission had to make seven affirmative findings under Section 13-506.1(b) and "consider" six additional policy goals set out in Sections 13-506.1(a) and others listed under 13-103 of the Act. With respect to these latter policy goals, the Commission concluded that, although an overall assessment as to whether the Plan "constitutes a more appropriate form of regulation" is required, it was not necessary to make an affirmative finding on each and every one. (Alt Reg Order at 180). In determining that the Plan met these regulatory criteria in 1994, the Commission expressed expectations as to how they would be met. (Alt Reg Order at 179-192). Here we will proceed to examine the Plan's performance in the context of those expectations and statutory demands.

In this section, we observe that a number of the provisions to be examined either overlap or are otherwise related and, hence, it is appropriate in these instances that they be considered jointly.

1. Has the Plan Produced Fair, Just, and Reasonable Rates

Authority: Sections 13-103; 13-506.1(a); 13-506.1(b) and the Alt Reg Order.

In 1994, noting that Ameritech Illinois' last general rate case had been in 1989, the Commission conducted a traditional earnings analysis to establish an appropriate starting point for noncompetitive service rates under the Plan~~;~~ and adopted a price index to ensure that those rates remained fair, just and reasonable over time. The Commission found that this index would continue to produce reasonable rates because it appropriately reflected the impact of economy-wide cost changes which should be flowed through to consumers, less an appropriate productivity offset. The Commission further found that, by linking price changes to cost changes in the economy (rather than to the Company's own internal costs), the Plan would "protect ratepayers from the impact of competition and management error." The Commission also noted that, given the magnitude of the productivity offset which had been selected, both the "real" and actual prices of noncompetitive services were likely to decline. (Alt Reg Order at 186).

AI's Position

AI maintains that noncompetitive service rates performed precisely as the Commission expected. The price index included appropriate measures for both inflation (GDPPI) and the productivity offset, which flowed through to consumers all of the productivity gains achieved by the Company during the 1995-99 period. As the Commission had predicted, AI maintains, the real and actual prices of noncompetitive services fell significantly over the 1995-1999 period.

In this proceeding, Ameritech Illinois provided external benchmark comparisons to further support the reasonableness of its noncompetitive service rates, referencing the standard of "affordability," which is set out in Section 13-103(a) of the Act. By comparing rate changes under the Plan to both the CPI and changes in wage levels over the 1994-99 period, the Company claims to have demonstrated that its noncompetitive rates are significantly more affordable today than they were in 1994. AI maintains that its rates are also lower than those of other telephone companies, both in Illinois and nationwide, and are comparable to those of its Illinois competitors.

The Company asserts that the GCI position, that fair, just and reasonable rates must equate to what would result from a traditional rate case, is inconsistent with the economic and policy underpinnings of price regulation, not supported by the Alt Reg Order and would give Section 13-506.1 a wholly nonsensical interpretation .

According to AI, the meaning of the term "fair, just, and reasonable" under Section 13-506.1 must be considered within the context of the overall purpose of the statute and the Commission's 1994 Order. AI asserts that Section 13-506.1 of the Act clearly empowers the Commission to substitute alternative forms of regulation for rate of return regulation in toto:

> Notwithstanding any of the ratemaking provisions of the Article or Article IX that are deemed to require rate of return regulation, the Commission may implement alternative forms of regulation in order to establish just and reasonable rates for noncompetitive telecommunications services including, but not limited to, price regulation, earnings sharing, rate moratoria, or a network modernization plan. Section 13-506.1(a). (Emphasis added).

A plain reading of the statute, AI claims, shows that "just and reasonable" rates are based on and measured against something other than traditional rate of return principles. To assert otherwise, AI claims, is to devise a circular proposition: i.e., the Commission can approve alternative forms of regulation, but only if they produce precisely the same rates as a traditional rate case. Interpreting the statute this way, AI claims, would be nonsensical and outside the accepted canons of statutory construction.

AI asserts that the incentive mechanisms which lie at the heart of price regulation -- and which deliver benefits to consumers in the form of improved efficiency, investment in the network, and innovation in services -- are based on the premise that there is no ceiling on earnings. Indeed, by subjecting itself to price regulation, AI maintains, it "assumed the risk" of earning less than a reasonable return on equity and rate base, in exchange for the "opportunity" to earn in excess of what would typically be authorized in a rate of return environment. This was the understanding in 1994. (See, Alt Reg Order at 7-12, 181-82.). Further, AI points to Staff witness Dr. Staranczak's testimony as additional support:

> "Under alternative regulation subscribers receive a guarantee that their overall rates will rise less than general inflation while Ameritech Illinois gets the opportunity to earn higher returns. If Ameritech does indeed earn higher returns under alternative regulation this should not be interpreted as a failure of the Plan but recognized as one of the possible outcomes that was anticipated." (Staff Ex. 2.0, pp. 4-5).

In response to persistent questioning by GCI attorneys, AI argues, Dr. Staranczak testified unequivocally that earnings are irrelevant in determining whether the Plan functioned properly. (Tr. 1249-54, 1266-67, 1281-82, 1284).

The assertion that high earnings might raise a "warning flag" that the terms of the Plan may have been too favorable to the utility, must also fail, according to AI. Such "warning flags" it contends, do not translate into rate cases unless the record demonstrates that the price index seriously malfunctioned. AI contends that is not the situation here where the price index was set properly, AI implemented the required rate changes, and there is no evidence shows the resulting noncompetitive service rates to be unreasonable. Simply because the Commission required the Company to report earnings data to provide an "early warning" that the index was misspecified says nothing about reinitializing rates AI claims, particularly where as here, the index worked properly. And, the Commission's expression of a willingness to reconsider earnings sharing also says nothing about reinitializing rates as even earnings sharing plans assume that earnings will exceed what would result from a conventional rate case.

Further, the contention that an earnings analysis must be performed for Ameritech Illinois' total intrastate operations is incorrect, as a matter of law, according to the Company since both Section 13-506.1 and the Commission's 1994 Order clearly limit the Plan to noncompetitive services. Contrary to GCI witness TerKeurst's assertions, neither Section 13-506.1(a) (which authorizes the Commission to adopt earnings sharing), nor the "public interest" standard in subsection (b)(1) extend the application of the statute to competitive services. Similarly, the Commission's 1994 Order expressly excludes competitive services from the operation of the Plan:

> Price regulation directly ensures that noncompetitive rates will remain just and reasonable, while market forces will control competitive service prices and earnings. (Alt Reg Order at 187.)

There are, AI recognizes, substantial disputes between it and the GCI/City relative to competitive service rates, competitive service reclassifications and the pricing actions which the Company has taken over the last five years relative to those services. AI contends, however, that competitive service prices are not within the scope of this proceeding, which was initiated to assess the functioning of the Plan. According to AI, the Plan cannot reasonably be indicted based on service rates and earnings to which it was not subject in the first place. The outstanding issues associated with service reclassifications, AI contends, should be and will be, resolved in other proceedings, such as Docket 98-0860 (competitive classification of certain business services).

Thus, AI argues, even if the Commission were to use an earnings analysis to evaluate whether Ameritech Illinois' rates are just and reasonable -- which it should not –such an analysis would have to be limited to noncompetitive services. AI asserts to have demonstrated that its 1999 earnings on noncompetitive services were only 5.55%, well below Ameritech Illinois' weighted cost of capital under either Staff's analysis or the Company's. According to AI, no party either disputed the mechanics of this allocation methodology or demonstrated that the results were in any way unreasonable. Indeed, AI notes Staff witness Hoagg's testimony wherein he stated that he that he would only be concerned if Ameritech Illinois' noncompetitive services were generating extremely high earnings, over an extended period of time, and, even then, only if further investigation revealed that these earnings were inconsistent with the policy underpinnings of price regulation. (Tr. 1223-26). None of these factors apply here, says AI.

To the extent that GCI witness Dr. Selwyn and Staff witness Marshall reject the Company's noncompetitive service earnings analysis, on grounds that jointly used plant and common costs cannot be meaningfully allocated between competitive and noncompetitive services, AI claims they are wrong. According to AI, jointly used plant and common costs have been separated between the state and interstate jurisdictions for ratemaking purposes for decades through the separations process. Regulated costs are routinely separated from unregulated costs to comply with the FCC's Part 64 requirements and Part 711 of this Commission's rules. Common costs are routinely allocated between competitive and noncompetitive services under the Aggregate Revenue Test to comply with Section 13-507 of the Act for ratemaking purposes. (See, Illinois Bell Telephone Company v. Illinois Commerce Commission, 203 Ill. App. 3d 424, 561 N.E.2d 426 (2nd Dist. 1990); See also, Order Docket 89-0033 (Remand), adopted November 4, 1991, at 200-203). In fact, AI notes that professional economists testifying in the 1994 proceeding, including Dr. Selwyn himself, proposed allocation methodologies to separate competitive and noncompetitive service earnings. (Am Ill. Ex. 1.3, pp. 24-25). The Company claims that its analysis is based on essentially the same approach as the Aggregate Revenue Test and provides a valid basis for determining noncompetitive service earnings.

So too, AI maintains, the GCI contentions that the Company's earnings demonstrate that the Plan was "mis-specified" are not supported by the record. To the contrary, AI maintains, Dr. Meitzen's analysis showed that the X factor was too high over this period. As such, AI asserts, this means that noncompetitive service customers received more benefits than they were entitled to, not fewer.

The City claims that the Company's earnings cannot be explained by improved productivity are proved wrong by the record, AI contends. To be sure, Ameritech Illinois' total factor productivity growth rate increased from 2.2% over the 1984-91 period to 4.2% over the 1992-99 time period. Thus, AI notes, it almost doubled. Furthermore, this data represents growth in TFP; that is, even if it had remained at the 2.2% level, the Company would still be increasing its productivity year-over-year by 2.2%. The fact that the 3.3% overall X factor did not change -- which the City of Chicago relies on for its statement -- is a function of the fact that the Commission overstated the Company's future input price performance in 1994 and the parties' unanimous proposal to shift to an industry-wide TFP figure. It does not, AI asserts, represent stagnant productivity performance.

AI would dismiss as untrue the CUB and the AG contentions that it would not have achieved these earnings in a competitive industry. AI witness Dr. Avera explained, that this was a period of record economic growth and record corporate profits. (Am. Ill. Ex. 8.0, pp. 8-10). The evidence shows that companies in fully competitive industries reported earnings of which, in CUB's words, Ameritech Illinois "can only dream". For example, AI notes that in 1999, Quaker Oats, General Mills and Campbell Soup outstripped Ameritech Illinois' return on equity by over 13 thousand, 20 thousand and 25 thousand basis points, respectively. (Am. Ill. Ex. 1.4, p. 28). It is a fiction, AI contends, that the "reasonable return" produced by conventional rate case analysis bears any necessary relationship to what actually transpires in competitive markets. It is a necessary fiction in the world of rate of return regulation, but it should not be confused with reality.

AI notes that both CUB and the Attorney General rely on Ms. TerKeurst's comparison between the earnings of the major BOCs over the 1990-99 period, - based on ARMIS reports to the FCC - in order to argue that Ameritech Illinois' profitability greatly exceeded that of its peers. AI disputes the validity of this comparison. The record shows, AI contends, that it treated certain industry-wide accounting changes (i.e., FAS 106, FAS 112 and FAS 71) differently for ARMIS reporting purposes than did the rest of the industry. As a result of this anomalous accounting treatment, Ameritech Illinois' total stockholder equity had dropped by 50% by 1994-95, which, in turn, artificially inflated its "earnings" relative to the other BOCs. AI points out that Ms. TerKeurst herself agreed that no meaningful comparison can be made between companies' earnings unless the underlying data is stated on a consistent basis. (Tr. 2174-75).

The reasonableness of Ameritech Illinois' competitive service rates is beyond the scope of this proceeding, which is directed at the performance of the Plan over its initial term. The Plan, both by its terms and by statute, is limited to noncompetitive services and the GCI's statutory citations are unavailing. Section 13-506.1(b)(4) reference to Section 13-103(a) does not expand the scope of this section i.e. all of Section 13-506.1 follows the prefatory language which authorizes the Commission to implement "alternative forms of regulation" in order to establish just and reasonable rates for "noncompetitive telecommunications services." (220 ILCS 13/506.1).

Ameritech Illinois does not dispute the fact that other provisions of the Public Utilities Act provide the Commission with "just and reasonable" authority over competitive service rates i.e., Sections 9-250 and 13-505(b). Nothing in the Commission's 1994 Order, however, even remotely suggests that competitive service rates were to be the subject of this proceeding.

For services properly classified as competitive, AI maintains, the issue of "just and reasonable" rates is far more complex than the earnings review on which GCI is relying. To be sure, AI contends, any regulatory restrictions on competitive service pricing should apply even-handedly to all providers of that service. This has been the Commission's practice to date and IXCs and CLECs have routinely been exempted from rate of return regulation in their certificate application proceedings. Thus, before embarking on any analysis of Ameritech Illinois' competitive service rates, AI maintains, the parties would have to address what standard other than earnings would be used to determine "just and reasonable" rates. And, in order to establish industry-wide pricing rules, IXCs and CLECs would have to be provided notice and an opportunity to participate. No such notice, AI claims, was issued in connection with this proceeding.

Finally, AI asserts, even if competitive service rates were at issue in this proceeding -- which they are not -- there is no evidence that they warrant a $1 billion rate decrease. As CUB acknowledges, only "some" of them have been the subject of rate increases. (CUB Init. Br., at 34). Ameritech Illinois believes that these rate changes were appropriate in the marketplace and as to the remaining services whose rates have not changed, there is absolutely no evidence that their rates are too high. The mere fact that Ameritech Illinois' competitive services generate higher earnings than noncompetitive services reflects long-established pricing policies and says nothing about their reasonableness: they are competitive largely because they are profitable and profit margins attract competitors. Given the poor returns generated by noncompetitive services (5.55%), Ameritech Illinois' financial viability has depended on and continues to depend on the fact that competitive services in aggregate earn substantially above its authorized return.

Staff's Position

Staff maintains that the most significant regulatory and statutory goal which an alternative regulation plan must meet is to guarantee just, reasonable and affordable rates for non-competitive services. According to Staff, alternative regulation plans serve this desired end by regulating the price of those services as opposed to regulating a company's earnings.

Staff asserts that Ameritech Illinois' noncompetitive rates today are just and reasonable. Its supporting analysis is quite simple:

> "If rates were set at a just, reasonable and affordable level in 1994, and thereafter declined, notwithstanding modest levels of inflation, it stands to reason that such rates are now a fortiori just, reasonable and affordable." (Staff Init. Brief at 30).

Staff takes issue with the GCI's recommendation that rates be reinitialized in this proceeding based on Ameritech's earnings. The arguments advanced in support of reinitialization are unconvincing, Staff asserts, because they do not focus on rates, but rather upon AI's rate of return or other matters extraneous to the Plan itself, such as reclassification. Such arguments, Staff contends, betray either a failure to understand, or to accept, the concepts behind performance-based regulation, which focuses primarily on the regulated company's price performance, rather than on its earnings. The essence of the GCI/City's error, in Staff's view, is that they simply refuse to grapple with this principle.

Staff notes that the Commission should not assume, however, that it is in complete, or even substantial, agreement with the Company. While Ameritech might suggest that the incentive mechanisms which underlie the fundamental superiority of alternative regulation vis-à-vis rate of return ("ROR") derive from, and depend on, an absolute absence of a ceiling on earnings under alternative regulation, Staff clearly disagrees. This type of "sky is the limit" view on earnings, Staff maintains, is simply unsupportable.

Staff believes it has well-demonstrated that the proper standard to be applied under alternative regulation is not the imposition of rate levels associated with rate of return regulation, but rather an evaluation of whether the Plan produces affordable, just, and reasonable rates – a price performance analysis. To the extent that AI would contend that an earnings analysis has no place in an alternative regulation environment, i.e., that any level of earnings produced by a plan are acceptable, and that any rates produced by a plan are, by definition, just and reasonable, it is wrong.

According to Staff, the statutory fair, just and reasonable rate standard places upper and lower limits on acceptable rate levels under an alternative regulation plan, and earnings levels associated with those rates. For a variety of reasons, the "zone of reasonableness" of rates is broader and more elastic under alternative regulation than under rate of return regulation. This is an inherent part of the alternative regulation "compact" and reflects such realities as increased competitive entry, generally increased risk for the regulated firm, and the potential for increased benefits for all stakeholders, notably consumers. Nevertheless, Staff asserts, the zone of just and reasonable rates under alternative regulation is far from being unlimited.

It is bounded on the lower end, Staff explains, by considerations of financial integrity of the regulated company, and its attendant ability to deliver appropriate levels of service availability and quality. To illustrate this concept, Staff assumes that Ameritech's financial condition had deteriorated during the Plan to a degree that threatened its ability to provide adequate service to consumers. There can be no doubt, Staff contends, that in this situation, the Commission's statutory responsibilities would require it to intercede by adjusting prices and/or key plan parameters to forestall or ameliorate significant adverse consequences.

The zone of reasonableness, Staff asserts, is bounded on the upper end by earnings levels that clearly exceed those that could be explained by enhanced cost effectiveness, and technical and market progressiveness of the regulated company. Beyond this bound are earnings levels associated, at least in part, with such things as significant misspecification of Plan parameters, misapplication of the Plan, or behavior that successfully defeats the overall effectiveness of an alternative regulation plan.

These bounds and the fair, just and reasonable standard under alternative regulation are not readily susceptible to prior or precise quantification, Staff contends. To achieve the desired end, requires informed regulatory judgement and analyses. This does not, however, diminish the importance of these bounds, or call into question their existence. Since prices alone do not provide directly the required information, earnings appropriately and necessarily are used as a proxy indicator. This is the major role of earnings analyses in any review of an alternative regulation plan. Having applied its judgment, Staff concludes in this proceeding that Ameritech's rates and related earnings are not outside the zone of reasonableness, either on the low or high side, and notes the absence of persuasive evidence to the contrary. It must be recognized however, Staff claims, that prices and associated earnings outside this zone might have occurred, and there was no assurance in 1994 against such a result. Similarly, it is conceivable that this might still occur in the future under an extension of the alternative regulation plan, despite the expectations or intentions of the Commission, Ameritech or other parties.

For this reason, Staff recommends that an extension of the plan should provide for a review comparable to this proceeding, to be concluded no later than five years from the date of extension of the Plan. An analysis of Ameritech's earnings, as well as its price performance, Staff maintains, should also be an integral component of that review.

GCI/City's Position

CUB claims that the rates currently being charged under the Plan are *not* just and reasonable based on the analysis that GCI/City witness Smith performed of the Company's pro forma income statement and the hundreds of data requests he reviewed in order to assess the earnings of AI under the price cap plan and to propose adjustments. His work, CUB contends, showed an AI intrastate return on equity of a staggering 43.08% -- nearly four times the authorized return on equity established by the Commission in the Alt Reg Order. On the basis of Mr. Smith's calculations, CUB claims that AI is currently overearning by approximately $956 million for AI's intrastate operations.

According to CUB, the Company's own assessment of its 1999 intrastate operating results(which include AI proposed adjustments to intrastate revenues and expenses), also reflects an astounding 24.53% return on common equity or more than double the cost of common equity approved by the Commission in 1994. These results, GCI witness Smith noted, indicate that the present plan has permitted the Company to dramatically overearn, such that rates must be reduced significantly before any new regulatory plan is established.

While AI asserts that rates are just and reasonable because annual overall revenue reductions have been passed through each year since the inception of the price cap plan and the revenue reductions passed through to consumers under the plan exceed what might have occurred under rate of return regulation, CUB finds the testimony on these points unpersuasive.

According to CUB, only a small portion of the cited revenue reductions were applied to residential usage rates. CUB further claims that some residential customers experienced rate *increases* under AI's price cap plan, depending on the calling plan selected. In addition, the Company's reported level of earnings shows that AI is earning more than double the authorized level of intrastate earnings that was adopted by the Commission back in 1994, thus confirming CUB's view that the rates AI charged to its noncompetitive customers declined far less than the Company's actual costs. Finally, AI witness Gebhardt admitted that his tally of a purported $943 million in cumulative rate reductions to customers does *not* include the increases in rates that have accompanied AI's reclassification of "noncompetitive services." (Tr. at 398-399.)

According to the AG, the fact that some prices decreased as a result of the Plan, does not show anything other than that the mechanics of the plan were followed and operated as intended to decrease rates. (AG Initial Brief at 24)

AI witness Gebhardt's comparison of what would have happened to rates under rate of return regulation is flawed, CUB argues, because it assumes the Commission would not have instituted any rate case over the life of the plan. According to CUB, Staff witness Mr. Hoagg indicated that with the rapid growth in demand for telecommunications services provided by AI and the earnings performance of the Company over the life of the plan, it is likely that the Commission would have instituted one or more revenue investigations which may have resulted in aggregate revenue and rate reductions.

While AI argues that the Commission's examination of the justness and reasonableness of its rates should be based on an "affordability" analysis that compares telephone rates with the changes in the consumer price index ("CPI"), wage levels and the rates of other local exchange carriers, on the theory that customers are more interested in the price they pay relative to the value they attach to the service, CUB disagrees.

CUB notes that Mr. Gebhardt chose a comparison of rates of other LECs, and not competitive carriers, for purposes of defending the Company's rate levels. Such is the case, CUB claims, because there is insufficient competition in the local market to provide any other comparison. Examining other LECs' rates is a poor criterion for measuring the justness and reasonableness of AI's rates according to CUB. As noted by GCI witness TerKeurst, AI is one of the lowest cost incumbent LECs in the nation and AI's earnings were are also some of the highest among incumbent LECs. Given its lower costs and higher earnings levels, it is reasonable to expect that AI's rate would be lower than those of other incumbent LECs. Because AI is still the monopoly provider of residential local telephone service, and a comparison of prices of competitors is impossible, CUB believe that the criterion of "affordability" requires an examination of the Company's costs and earnings.

CUB also notes Dr. Selwyn testimony that, if a "competitive outcome" analysis cannot be conducted due to a lack of competitors, then the other principal means by which the justness and reasonableness of AI's rates can be judged is on the basis of the Company's earnings. For example, if AI consistently earns a return on its investment that is well in excess of the rate of return that the Commission would customarily authorize under rate-of-return regulation *and* is higher than would be expected to arise under competitive market conditions, then according to Dr. Selwyn, it is reasonable to conclude that AI's rates are excessive and thus violate the "fair, just and reasonable" requirement. CUB further notes GCI witness TerKeurst observations that, while it may not be possible to determine with precision what rates would have been under rate-of-return regulation, i.e., when rate cases would have been held or with what result, it is clear that Ameritech Illinois would not have been allowed to reap its current earnings levels.

According to CUB, there is no provision in the Alt Reg Order or in Section 13-506.1 of the Act to suggest that the regulatory compact inherent in the approval of alternative regulation includes an open-ended right to unlimited, excessive earnings. If anything, CUB claims, the Alt Reg Order includes numerous provisions that reflect the Commission's desire to monitor the Plan and the Company's earnings in order to assess the Plan's performance. For example, the Commission noted that its decision to exclude earnings sharing from the Plan is not to be construed as a rejection of all earnings sharing mechanisms of the future. The Commission further stated that it would in future review proceedings, entertain evidence and argument of policy considerations for the provision of some forms of earnings sharing in a revised plan. (See Alt Reg. Order at 51).

According to CUB, the statutory requirement that rates be fair, just and reasonable is not limited to noncompetitive services. And, as intervenor witnesses TerKeurst and Selwyn point out, a regulatory plan that produces reclassification of services to competitive with corresponding price *increases* does not further the goal of fostering competition or providing just and reasonable rates.

Further, CUB claims, all of AI's local and intraLATA services are furnished using a common set of network infrastructure and other corporate resources. As noted by Dr. Selwyn, the FCC has concluded that it was not possible to develop jurisdiction-specific estimates of total factor productivity because no economically meaningful separation of state and interstate inputs could be made. This same reasoning, CUB contends, applies to services labeled as competitive and noncompetitive here. And, because the Commission no longer requires detailed cost studies to support "competitive" services, CUB claims that it has no adequate means of determining whether AI is over allocating costs to noncompetitive services and thereby depressing the noncompetitive rate of return, while under allocating costs to competitive services.

CUB notes that when the Commission first approved price cap regulation for AI in 1994, only 7% of the Company's revenues were derived from competitive services yet today, AI reports that about 58% of the Company's intrastate revenues come from competitive services. This massive reclassification effort, CUB maintains, has been accompanied by rate increases for some of these services. As noted by Dr. Selwyn, "(t)he very fact that such rate increases were possible as an economic matter for services that were already priced in excess of their costs and that ostensibly faced